Unedited Event Transcript

Book Release Meeting

The Euro Trap: On Bursting Bubbles, Budgets, and Belief

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Adam S. Posen: It’s my pleasure to welcome you back to the Peterson Institute for International Economics, which is of course a little piece of Europe in Washington. I say that only half-jokingly. It’s not because we’ve seceded from the US Scottish style, it’s rather that I think we can proudly say that we are the primary venue for serious, challenging, but supportive discussion of the European Project in Washington, if not the US. My many colleagues Angel Ubide; Nicolas Veron, Anders Aslund, Jacob Kirkegaard and of course, Fred Bergsten, have all been working this beat and we’re very proud to have a succession of high level visitors and speakers to help us engage on these issues.

Today, of course, we’re going to be speaking about and be addressed by Hans Werner Sinn, the author of *The Euro Trap*. I will introduce Hans Werner, an old friend and a distinguished role model, in a couple minutes. I’d just like to say for those of you who are not reading our e-mail newsletters quite as acidulously as you might or because I haven’t always gotten things out on time, we have a large assortment of very good European related meetings upcoming, particularly in the run up to the IMF World Bank meetings.

In particular, I would like to call your attention to three events. On Wednesday, October 8, we will be having a luncheon speech by Professor/Dr. Axel Weber, who all of you I hope know as the current Non-executive Chairman of UBS, but more importantly perhaps as the one other German besides Hans-Werner Sinn, who’s widely recognized and known in the US as a Macro-Economist, the former head of the Bundesbank.

Later that day, we will be having a panel discussion of the new multilateralism in development banks featuring Sir Suma Chakrabarti, the new head of the European Bank for Reconstruction Development, as well as Simon Johnson from our shop and Dominico Lombardi from CIGI.
On Thursday, October 9, we have our semi-annual joint meeting with Moody’s Investor Services and we have chosen to focus this on European issues as well. We’ll be having keynote addresses from Marco Buti, the Director-General of the ECFIN at the European Commission and Vitor Gaspar, the current head of the IMF Fiscal Department of the former Finance Minister of Portugal. Too many events being thrown together.

And also on Thursday, October 9, we will be doing the Washington release of Martin Wolf’s new book, *The Shocks and the Trends*, I believe, *Shifts*, thank you, *The Shocks and the Shifts*, yes, Martin would illiterate. And that’s going to be quite the festive public event.

Returning to today, Hans-Werner Sinn is of course the primary Professor of Economics at Germany’s, I’m allowed to say these things, Germany’s primary research university, Ludwig Maximilian Universität in Munich. He is also President of the Ifo Institute and the CESifo Group. We’ve let him put his logo up. This is of course the most private sector oriented, best forecasting and most active of all the economic research institutes in Germany. Hans-Werner Sinn has, like my predecessor Fred Bergsten, created something where there was not really anything before and it is in that sense I mean of him as a role model. He has built what is clearly the best economics think tank in Germany and throughout Central Europe.

He has more prizes than I care to list because it’ll make me depressed. But I think it’s very important to recognize his position as a public intellectual in the German economic debate, in the broader European economic debate, as a frequent columnist, as the author of bestselling books, both in German and in English, as ranked regularly among the most powerful people in Germany by such publications as *WirtschaftsWoche*. In 2012 he was the only German to be included in *Bloomberg’s List of the World’s Most Influential People in Global Markets*. Take that [inaudible 00:05:04]. And most of all he is the author of this controversial, provocative and yet worthy book, *The Euro Trap or Bursting Bubbles, Budgets and Beliefs*.

We will have Hans-Werner present his argument, then Hans-Werner will be followed by my predecessor, our Director emeritus C. Fred Bergsten with his slightly different views on Germany’s role in Europe and the World. And then we will open it up for public discussion.

So thank you very much for joining us, Hans-Werner if you please.

Hans-Werner Sinn: Thank you, thank you. Yeah, thank you Adam. I come from the Ifo Institute, which is a little bit of the United States in Germany. And I would like to talk today about Europe’s problems, the content of my book, and
all brevity, which is appropriate and I’m very grateful for being invited to
give this lecture here in the Peterson Institute, an Institute which has
shaped the international debate in policy issues very much and there are
many topics which we share.

And it shows you problematic pictures from the European crisis. We
thought the Euro was a peace project, as such it was announced but it has
created hassle and strife in Europe. It has created an intolerable situation
in Southern Europe and a situation which is also not very pleasant and not
felt as pleasant in Northern Europe.

In a sense we have fallen into a trap with this wonderful project Euro.
There was a big party, then there was the headache, and now we are
shouting at one another. This is not exactly what the protagonists of the
Euro had wanted, including myself: I really endorsed the Euro Project all
the time and was deeply convinced that we needed such a step to bring the
European integration forward.

I will speak about the bursting bubble, the competitiveness problem of
Southern Europe, the rescue operations, some budget constraints and what
I consider as a solution. But don’t expect too much, there is no good
solution. There is only the least evil.

Concerning the bursting bubble, look at this picture, which many of you
have seen. This is the interest spreads in Europe. This is one country,
which you all know, Greece. At the lower spectrum is Germany and then
there are all these other countries.

So when the Euro announced in 1998 and then the exchange rates were
irrevocably fixed, there was a period of interest conversions. The
exchange rate uncertainty had disappeared and the investors thought there
was only safe investment opportunities in Southern Europe. They
disregarded the bankruptcy risk, which is now the major problem.

And so there was a period when countries which formerly had paid very
high interest rates could borrow at very low interest rates, that was
tempting and so they did. The money went through the government sector
into wages of government employees. The money went into the
construction industry because there was a building boom, in particular in
Spain and Ireland.

In the end it made no difference how the foreign credit, which was
available at lower rates of interest, reached the internal economy via the
construction industry or via the government sector. There was an artificial
period of wage growth financed with foreign credit, which deprived these
countries of their competitiveness. And then after a 10 year period, when
everything seemed to work out well, when the American crisis swept over to Europe and banks all of a sudden became hesitant to continue lending and looked at possible risks, we had this bursting of the bubble. Interest rates in Southern Europe went up and then there were all sorts of rescue operations which brought them down again and so in a sense we overcame all the problems and the problems are solved.

But they’re not really solved. Here you see as an example what happened in the government sectors. This is Italy. The Italian debt/equity ratio was standing at 120% in 1995 when the Euro was announced and then it came down. At the time the Minister President Dini promised austerity and to use the reduction in interest rates to really pay back some of the debt, so he did. Then Prodi and all the other Minister Presidents came, but then came the period of Silvio Berlusconi and one thought, well why all this austerity? Let’s consume the interest reductions.

The interest reduction was enormous because Italy had this enormous public debt which had to be serviced and they saved more than their value added tax revenue through the introduction of the Euro. But they obviously used it for breakfast, rather than repaying the debt. And the current debt level approaches 140%, more than ever with the Minister President changing.

Had Italy used the money, which they had in their hands because of the interest reduction, which the Euro brought, guess what today’s debt GDP ratio in Italy would have been? Zero. Okay this is not a real calculation, this is a nominal calculation, but if you do it properly in real terms you get this curve and then you would be below 60%. That’s a fair calculation.

So it is very tempting, if you reduce interest rates through public mechanisms that suggest safety to investors, the incentive to borrow more is obviously stronger than the liquidity advantage of having to pay for your interest rates.

Now many people say the crisis is over. We are on the right track. The competitiveness problem is disappearing. The current accounts improve, indeed they do. The current account balance of the six European crisis countries, I call them Gypsic. It went to minus 200 billion as you see here in 2008 and thereafter during the crisis it strongly proved and we now have a current account surplus. So doesn’t this show that everything is fine and we can now return to normal life?

I don’t think so. If we look at exports and imports separately we see that things are not that good. Here you see Greek exports have really left their trend and imports even more so, and obviously the improvement in the current account in Greece comes largely through the collapse of imports.
And why do imports collapse? They collapse because the economy collapses. If you have a mass unemployment people can’t buy foreign TV sets and cars anymore. So that’s not exactly what one calls an improvement in competitiveness. Actually I think it has very little to do with that.

Let’s look at Spain. Spain is a much better performer. Here you see that Spanish exports are struggling to get back to their pre-crisis trend. Indeed they have succeeded. So the picture looks much better than in Greece. But even here you see all the movement comes from the import side. The imports who left their trends. It's again, the collapse of the economy which has improved the current accounts and not really an improvement in competitiveness.

And don’t forget the current account also measures interest payments. So the rescue operations, which we have carried out in Europe, have artificially reduced the interest rates way below the marketplace, meaning that fewer interest payments have to go abroad and that had a very strong, positive effect on the current accounts. Again, it has nothing to do with an improvement in competitiveness.

The unemployment problem in Europe is still strong. France has a high rate of unemployment relative to its history. Ireland has improved enormously. But here you have Italy increasing rate of unemployment. The youth unemployment in Italy is even above 40%. Portugal seems to be improving after a difficult period and here we have Spain and we have Greece, where we have unemployment rates in the order of 25%. Yes they’re improving, you could say the worst is over, but you never know.

Let’s look at industrial production. Here you see the advanced economies of the world and you see here the emerging economies and the dot here is the beginning of 2008 or the end of 2007, the level which we had then. And you see the advanced economies have just succeeded in reaching the pre-crisis level. What about all European countries?

Ireland, wonderful performance. Ireland really has done it for reasons I will explain. Germany is on the pre-crisis level. Portugal, France, very difficult picture, which is not that promising. Italy, a double dip recession. Italy is back exactly on the level they were in 2009 when the crisis hit them most. There was a period in between where it seemed that Italy would recover until the winter of 2011, but then in 11 the decline continued and a small wonder that Silvio Berlusconi, at the time had secret negotiations about an exit of Italy from the Eurozone. Actually together with Papandreeou and they both resigned then later right towards the end of the year at about the same point in time. There were three days between it
because the financial industry certainly did not want this to happen. Neither did important powers in Europe want that to happen.

This is Spain. Spain did not have a double dip recession, but a double dip depression. And this is Greece. So the question nowadays is will this turn out to be a triple dip? If you look at these curves at the right edge you’ll see they all are moving downwards. We’re expecting now a further cooling of the European business situation and possibly that’s what everyone fears, there is a further recession in Spain, in Greece, in Italy, in France, which would mean a triple dip recession or depression, if we talk about Spain. Let’s hope it will not happen. We don’t know. But there certainly is the risk.

Why is this so? Obviously Europe doesn’t have a Keynesian businesslike problem with the lack of demand. This cannot be the reason. The reason is structural. All these countries have become too expensive and they are too expensive in particular with regard to their new competitors in Eastern Europe. Because when they thought they joined the Euro, that was 1995, Eastern Europe was not really on the scene. The Eastern Europeans came however, 10 years later and they all joined the EU and they are now fierce low wage competitors.

Here you see the wage costs per hour in manufacturing for the Eastern European countries and let’s add our crisis countries in Western Europe and you see their wages are all way higher. Look here for example at Greece versus Poland. Greece has wages of 14 Euros, while Poland has those of 7 Euros. The Greek would have to be more than twice as productive as the Poles to make this compatible with competitiveness, but of course they aren’t. The Poles are very efficient, productive people. No way to compare that.

Or let’s look at Spain versus Poland. Spain is sitting here at 23 Euros, more than three times as expensive as Poland. There is no way this is sustainable. No dream of European politician can solve this problem. It’s an insurmountable problem for Southern Europe. They really went into the trap. Cheap money, low interest rate, party, extension, the internal sector of the construction sector. The whole economy through the service side was girded up and no one is sitting there with wages which are way too expensive relative to what is compatible with international competitiveness. That’s the problem. They need an internal devaluation.

What have they achieved? Let’s look at the price levels, the GDP deflator, relative to the respective rest of the Eurozone. Here you see Spain. It’s all normalized, such at the time of Lehman we just reach a level of 100. They start at 80 and go to 100. Obviously 25% relative price increase for Spain. Relative to the competitors in the Eurozone and that killed them. They
would have to turn back. If they want to stay in the Euro they have to cut their prices relative to the rest of the Eurozone or the Germans have to inflate.

But the path is long. There is an interesting study by Goldman-Sachs and they say that they have to go down, not by 6% as they did during the crisis, but by 34% relative to the rest of the Eurozone, not relative to the average. That’s another calculation. So it’s quite enormous.

Yes, they did their homework. There were reforms and you see something has happened, 6% real devaluation throughout the crisis years is something. But it is very little relative to what is necessary.

Here we have Portugal. Portugal has not depreciated in real terms at all, well 1-2%, it’s negli volente would have to go down quite a bit.

This is Greece. Greece also declined. The first years of the crisis, they increased their prices and wages even more than the other European countries. But in the last two years, they’ve found the turn around and indeed their price level has come down now. But has it come down sufficiently?

Here is France. France is the surprising thing. France always inflated like the European average, so they didn’t seem to have a problem but according to the Goldman-Sachs calculations they would have to come down by 24% anyway. France has just 10% value added in GDP, which is less than half of what Germany has. And the trend is a straight line leading to the origin.

Italy needs a little devaluation of 11% and it has not devalued at all during the crisis. Italy kept inflating like the average during the crisis before. All the years before Italy inflated like hell relative to the rest and they lost their competitiveness, and during the crisis they should have gone into the back year, they didn’t. That will be [inaudible 00:24:26] task, to carry out reforms that make wages downward flexible and allow prices to decline.

Of course, there could be a productivity miracle that would bring the same and result in lower wages. But where is this miracle? I don’t see it. And even if the miracle happens will wages stay constant without changing the labor market? The wages would automatically follow the productivity and you would not be able to cut their prices.

Only Ireland has achieved what is necessary. Ireland cut its prices relative to the rest of the Eurozone by 15% and they have done their job.
And this is Germany. Germany deflated all the time in relative terms, not in absolute terms, but they inflated less than the others and they became cheaper and cheaper and that is part of the problem of the others. And Germany would have to increase its price level by 30% to rebalance the whole Eurozone, while others will have to go down by 30%.

Why did Ireland do it? My interpretation is the Irish crisis began earlier. Already in 2006 that’s when the bubble burst and they understood that they had to do something; they had to incur austerity. There was no one helping them. No program of the ECB and no rescue program, nothing at that time and they cut their wages and prices and thereby they improved their competitiveness. While all the other countries came into the crisis simultaneously after Lehman and they found other ways to handle the crisis rather than going the austerity path.

We now are really in a trap and there are four dismal options for Europe, in particular the Southern European countries. Well first we could accommodate the structural deficits with ongoing transfers, we create a transfer union, but this would create a sort of dependency, a long term dependency, a Dutch disease phenomenon, which would permanently keep the manufacturing sector down.

We could deflate the periphery through austerity. But that’s easier said than done. You cannot easily cut the prices given that the situation arose, because of excessive debt all these people are over indebted. The government sector is over indebted. Private people are over indebted. They have to do their debt service. You cannot simply cut their wages and prices in half because then they would not be able to service their debt. And some prices are not flexible. Long term contracts are not flexible. So it is not so easy. Caines was right when he pointed to the difficulties. Mass unemployment and insolvencies are the result of such a strategy.

Well we could inflate the core. Germany could inflate but it would have to inflate by 71% if we wanted to avoid an actual deflation in some of the other European countries. That would deprive German savers of 40% of their wealth.

Will it happen? I don’t think so. And even if Germany tolerated it, is the ECB able to create such an inflation? Not so clear. How do you do inflation? By cutting the interest rates. Not if you’re in a liquidity trap. You have used your powder already. It’s not so easy, even if you wanted to do it. And it would be violating the mandate of the ECB. The ECB has only one mandate, that is keeping prices constant. Unlike the Fed, it is limited to this one mandate.
Or we have exits. Exit is very ugly because when you talk about it then all of a sudden you have a bank run, you have capital flight, we have all these nasty things, which we see in Cypress. We have two Euros by the way, today. We have one in Freedom and one in prison in Cypress. The Cypress prison has not the same value as the other Euro because you can’t get it out. That would happen on a large scale if we talked about exits.

So it’s really a mess. None of these options is really pleasant. This doesn’t mean we should do nothing. I will towards the end speak about what I think we can do. For the time being, Europe sought the solutions in rescue operations and here in particular in rescue operations by the ECB. It was the printing press that solved the problem for the time being. The ECB consists of many national central banks. They all are allowed, according to the rules of the ECB, to print money, issue the money, lend it out to the banks, and that’s what they’ve done. What they did in Southern Europe, when the private credit was no longer coming from Northern Europe to Southern Europe, financing the card account deficits, it was replaced with a printing press. So the credit from the printing press did the job for the time being.

And that was possible because the ECB changed its rules under which the local printing press could be activated. They reduced the collateral requirements for the credit. The central bank prints the money, lends it out to banks and takes the collateral to make sure there is no risk. But the collateral requirement was gradually reduced. I have a whole chapter in the book explaining in detail what happened here, which kinds of collateral were reduced to what level. It’s a very, very complicated thing. I’ll just give you a few aspects.

So we went from A minus to BBB minus for general assets. Then when the rating agencies declared the government bonds of Portugal, Greece, and Spain, no investment grade, then the ECB said, “Oh well, we don’t care. We still accept it”. We still accept it as good collateral. Thereby it liberated lots of assets in the balance sheets of banks for the purpose of being handed it as collateral and drawing the credit from the local printing press.

And then there were ELA, emergency credit where even the common denominator for these collaterals was not necessary because there was affection, there was national responsibility and so on. There were non-traded ABS papers, which were allowed. It’s a long story. It’s a breathtaking story. I cannot lay it out here in detail.

But basically it meant that the printing press was underbidding the market. Market investors didn’t want to bring credit to Southern Europe anymore and if so at terrifically high interest rates and so it was much more
tempting to draw the credit from the printing press. That was the solution for the time being, when the Lehman crisis hit.

And the result is that the production and allocation of money balances in the Eurozone really differs a lot. This is the monetary base of the six crisis countries. It is about 30% or so, 25% of the total monetary base in the Eurozone, which is 100.

This is the money circulating in the non-crisis countries and below the yellow curve is the money circulating in the crisis countries. But this is the money produced in the crisis countries and above the white line you have the money produced in the non-crisis countries and the difference is the extra credit from the local printing presses, which helped solve the problem. You see the thing is going down, but at the peak it was 57% of the entire monetary base of the Eurozone, which was a big rescue program allowed and facilitated through the actions of the ECB Council without parliamentary control.

For Germany, for example, it meant that while this is the monetary base of Germany the money produced in Germany itself through credit operations went to zero. At the peak of the crisis in the summer of 2012 there was not a single cent in Germany, which was created by the Bundesbank and lent to the banking sector. All the money, which circulated in Germany, was cabled in from Southern Europe. The Southern Europeans printed the money, bought the goods in the North, redeemed their debt in the North, bought assets in the North, and that money crowded out the money which usually comes directly from the Bundesbank through credit operations. It was extreme in the true sense of the word. It was not a marginal operation.

Overall, I see the following steps of the crisis. To repeat some of the things I’ve said. First, we had he current bubble in the Southern Europe, the Euro created this artificial safety for investors, interest spreads disappeared, excessive borrowing that led to the inflationary credit bubble, depriving the Southern European countries of their competitiveness.

Then all of a sudden private investors didn’t want to continue financing the current account deficits and the printing press was the solution, replacing the credit, which came via private markets.

Then the ECB said, “This is a little bit dangerous, we are too much involved and we have to do something against this.” They began forcing the central banks to buy the government bonds off the Southern European countries, something unheard of in America. The Fed would never, ever, as far as I know, buy government bonds of specific states, like California, Illinois or so, which are in trouble.
Then came the fiscal rescue operations. The ECB had made the prior decisions and then they said, “No, but we want to step out. You have to take over politicians.” So the politicians saw no alternative but to create huge fiscal rescue funds and the parliaments then made their respective decisions on these rescue operations.

But even that was not considered to be the solution because the parliament members were much more restrictive with their wallets than the ECB was and the money was not enough, which they were providing. And so the ECB then made the next step and said, “Let’s introduce the O&P Program. A promise to repurchase government bonds out of private investors’ portfolios if necessary. And that promise, of course, meant that investors dared again, to go to Southern Europe, buy the government bonds because they knew before a bankruptcy of the state they could go to the central bank and sell the government bonds to the central bank.

This was a Free of Charge CDS insurance contract, which the ECB offered for investment in Southern Europe. That worked a lot. It helped reduce the interest rates and brought in private credit replacing the public credit, which could partly be repaid through these mechanisms. But it was not the market. It was a Free of Charge public insurance for credit flows from Northern Europe to Southern Europe.

Savers in Northern Europe didn’t want to go to Southern Europe anymore. They had burnt a lot of capital. They wanted to retreat and do something else and then the ECB says, “No, we still want you to go and we insure your investment in Southern Europe.” Okay, then they go. But it’s a subsidy, something which is, in my opinion, alien to a market economy. The government is not to decide or the ECB is not to decide where to invest. It should be market forces. Investors who sit on their wealth portfolios should make the decision where to invest and out of these decisions come the allocation of economic activity in space. It’s not the ECB Council that determines where to invest but it is private investors in a market economy.

And then we have the banking union because through these guarantees for government once we can re-establish capital flows to the government sector but not into the private sector, which has a similar problem. So we need to do something with the banks and establish a sound banking system. I think this is very necessary. We need a banking union. We can’t have a joint responsibility for the credit. They all receive credit from the ECB and we have different rules by which we supervise the banks. That has to be normalized and has to be under common control. This you hear as to what extent will we socialize the bank risk, there are different opinions.
And the next step is now quantitative easing, which is in the making. The ECB has announced that it will not only give credit to the banks but in the future it will buy the assets from the banks sheets. The banks are very stressed in Europe. We have the stress test. There is a lot of difficulties and one of the solutions is to offer the banks that their assets could be sold to the ECB. This is in discussion at the moment. The rules are not yet clear. We can, perhaps later speak about that if we have time.

Basically capital markets have been calmed by shifting the investment risk away from the investors to the taxpayers in Europe. Because the taxpayers are also standing behind the ECB any loss of the ECB is a loss of the taxpayer because the inaudible 00:40:26 would no longer be distributed to the respective national treasuries.

Is this the right policy? I doubt because the taxpayers are ordinary people who understand very little about this thing. While the investors are very clever guys sitting behind their screen optimizing all the time. By shifting the risk from the clever guys to the ordinary, trusting people like parents and so on we calmed the situation, but simply because they don’t know what’s going on. That’s a very strange kind of policy.

Overall, if we sum up, here we have a column that gives you the maximum public credit through all these mechanisms, which was given to the six crisis countries, 1.339 billion Euros and of which the smaller part, just 17%, was controlled and decided by the parliaments of Europe and the largest part was decided by the ECB Council, namely 83% of the overall public rescue operations.

That is the issue in Europe. Because the ECB has not been given the mandate to carry out such risky rescue operations and redirect the capital flows. The ECB thinks it has the mandate, there are other opinions about exactly that issue. The German Supreme Court, for example has not ruled, but said in a public declaration in February, that it is not of the opinion that the ECB has respected its mandate. It has overstepped its mandate and it has misused its power. That it says verbally. It has now asked the European court about its opinion, but not to take over the case, but just to see whether they have an argument.

And the issue is not yet clear. We will come to the ruling of the German court in next February and should the European Council say everything the ECB did was okay then the German Court will probably say, “Well we respect you, you’re the superior court, but unfortunately this is not compatible with the German constitution.” So Germany has to either change the constitution or get out of the Maastricht Treaty. And changing the constitution cannot be done with two-thirds majority in Germany.
because it is one of the clauses with eternal validity, which is affected here, so we need then a referendum.

Overall, I think we had very soft budget constraints in the Eurozone. I use this term of Janos [inaudible 00:43:55], which he used to describe the difficulties in the Soviet Union. “Market economy can never work with soft budget constraints. It needs hard budget constraints.” But all these policies are to the opposite. Well from the Keynesian point of view there are lots of arguments you can make for temporarily loosening the budget constraints and so on. We all know the arguments. But we are now seven years after the outbreak of the crisis. Is there still Keynesian deficit management which we need? I doubt that. The crisis has very, very little to do with Keynesian mechanisms and Keynesian recipes. Of course, Keynesian recipes are a drug that kills the pain. That is true and that helps for the time being. But it is not a cure.

Basically we had too little care from the beginning. Investors were negligent when they went to Southern Europe, too low interest rates because there was the bailout option at the horizon. So this inflationary credit bubble happened, overheating. The competitiveness was lost and now we have systems of introducing joint liability for the debts that were built up. Again, artificially reducing the interest rates, but that brings us back to the same kind of problem with which we started.

If we artificially reduce the interest rates through common joint guarantees there is an incentive to over borrow, as I showed in the Italian case. That is fine for a couple of years, but then the mess will even be bigger. And I repeat, there is no analog to the United States or Switzerland. In Switzerland if a canton over borrows it goes bust and no one helps it. The same in America, no one even discusses the option of bailing out California, Illinois, or similar countries which are in difficulties. But Europe does that, even though Europe has not created the United States of Europe, which it should in my opinion. And the book ends like that.

The soft budget constraints are very dangerous and why? That you have seen in the American history. When Alexander Hamilton in 1791 mutualized the state debt that helped for a while because everyone could keep borrowing. The states kept borrowing, the interest rates were reduced, but then there was an inflationary bubble and that bubble burst in 1837 and from 1837 through 1842, 9 out of the 29 American States and Territories went bankrupt.

Harold James from Princeton University says, “Hamilton thought that his debt mutualization would be settling for the new state, but in fact it turned out to be an explosive.” Europe, I think, should try to learn from the
American experience and hear my solution. It’s not really a solution, but that’s what we should do.

We need a debt conference to cut some of the public debt, bank debt, target debt this debt residing from the credit between the central banks. We should allow for temporary exits of severely uncompetitive countries; exits, devaluations, the option to return at a later point in time at a new exchange rate. And then we need a system of harder budget constraints for central banks such that this local money printing in case of need is not possible.

Basically it’s a breathing currency union. We don’t have the European state yet. We don’t have mechanisms and can’t have mechanisms as you have it in America where you have some sort of transfers through public budgets, but you have also strong control from Washington of what the individual states do. As long as we don’t have created the United States of Europe.

For the time being, we can’t have the Euro in the old way. We need a system which comes closer to a Buchenwald system, something between the dollar and the Buchenwald system, a breathing currency union, that’s what I call it. Something where you can exit and investors know you can exit. They know there is an exit risk and therefore they charge high interest rates and because they charge high interest rates you don’t over borrow. This self-disciplinary device is absolutely necessary. If we don’t have that I’m afraid the European Project will never be able to succeed.

Thank you very much for your attention.

Adam S. Posen: So I come up and then you come up in the middle seat after you’re done. Thank you.

Thank you so much Hans-Werner. Beautifully paced, beautifully explicated, beautifully original and beautifully subject to discussion.

For that I turn to my friend and mentor, Dr. C. Fred Bergsten, as you know, Founding Director of the Peterson Institute, but two other qualifications are relevant.

First he was probably the first and certainly the foremost American Economist to come out and argue for the likely success of the Euro Project when it was first proposed in real form in the early 90’s and remains a staunch advocate of its viability.

And second he is just back from a successful tour in Berlin where he followed me for once as the Kurt Viermetz Distinguished Lecturer at the
American Academy in Berlin. So he’s been honing his arguments for a German audience, just as Hans-Werner Sinn has been honing his arguments for an American audience and we can now see the cultures clash. Fred.

C. Fred Bergsten: Well Adam, thanks and thanks to Hans-Werner for once again joining us, sharing with us his analysis of the European scene, which is both cogent and influential in Germany and Europe more broadly.

I will indicate some significant differences of view with Hans-Werner. But I commend the book to you. It presents superb analysis of a whole range of components of the crisis. It quantifies the Eurozone’s internal imbalances, both on the surplus side, i.e. Germany, as well as the deficit side that Hans-Werner stressed today.

It has a particularly important analysis of the Target II Settlement System, which he mentioned, but is really at the heart of the whole Euro system. It’s not very well understood. It is very important. Hans-Werner has personally done pioneering work on it and I commend that part of the book in particular.

He correctly interprets the European Central Bank as a fiscal bailout mechanism. I happen to think that was a good thing and necessary. Europe has no government. So in a crisis, the European Central Bank as the only paying European representative in my view, had to respond. Hans-Werner decries it and says it was not democratic remember that the ECB Council was not just a bunch of people sitting behind closed doors and making ex cathedra decisions. They represent governments. They consult with their governments. In the real world they are a highly political body and so I don’t think it’s quite as undemocratic as Hans-Werner mentioned. Moreover, I think it was absolutely essential to keep the Euro Project alive.

I must say that I particularly applaud one view that Hans-Werner expressed in the book. He, in addressing the issue of the trade imbalances, the surpluses and such, he referred to many of his own German colleagues as being, and I quote him, “Nothing but crude mercantilists” for thinking the trade surpluses in and of themselves are a great thing, a badge of honor, and something to be sought.” I’ll have a bit more to say about that later.

But having praised much of the analysis, I have to say that I found the message of the book, the main message of the book, both perplexing and puzzling. Hans-Werner as he indicated today, is a staunch advocate of Europe, of the Euro itself, even of moving to a United States of Europe. And he in fact starts his last chapter with a ringing lead line, “There is no
alternative to Europe and to the further integration of Europe toward a
greater union that is imperative.” These are Hans-Werner’s own words.

I contrast that, however, with my interpretation of his reform program. He
didn’t mention all of it this morning or this afternoon, he didn’t have time
to do it, but he really has a four or five point program. Which if you
consider it carefully I’m afraid would blow up Europe, not save it.

Point one, very hard budget constraints, his last point. That means more
austerity. Second, a gold standard monetary settlement, literally in the
book, gold settlements to replace Target II with its intergovernmental
credits. Three, a big debt conference to restructure the debts of the
peripheral countries, although at one point in the book he says, “Only
Greece for sure needs it, maybe Portugal,” so maybe in practice it
wouldn’t be quite as extensive as he suggests.

Most dramatically, point four, exit from the Eurozone for some peripheral
countries. Let them devalue and then let them apply and hope to bring
them back in. A pretty far reaching proposal to which I say something in a
minute.

And finally, if I understand Hans-Werner correctly, no mutualization of
anything. No common deposit insurance, let alone any kind of fiscal union
or Euro bonds. He denounces Alexander Hamilton for having made a big
error but Alexander Hamilton bought 50 years at the time the United
States was forming its union. He said that Hamilton’s error in 1791 started
to be realized with state defaults in the 1840’s. I guarantee you, if the
European leaders felt they could buy 50 years with some decisions along
those lines, they’d take it in a minute, Hans-Werner, and maybe that’s the
lesson of Alexander Hamilton, not the one you draw.

But my bottom line from his five point program is that each of its elements
are very dubious, very tendentious. I don’t believe likely to help, even if
they were feasible and trying to put them all together, even if there was an
effort to do it, seems to me that almost certainly would be an explosive
mix in the European situation. I don’t think, Hans-Werner, it would lead to
a breathing currency union, I think it would lead to one that at best would
be on a respirator and probably would expire in the fairly near future.

Just to mention one of those points, the idea of exits. Hans-Werner argues
in the book and to be fair he didn’t have time to lay all this out this
afternoon, Hans-Werner argues, “Let the countries with the high cost
situations exit and devalue.” And then he argues, “They would have a big
incentive to take on major policy reforms, so that they would be accepted
back into the union.” It seems to me he’s got it backwards. The countries
are making vigorous efforts now to implement economic reforms to stay
in the union to avoid having to exit. If they were to exit and you give them the alternative strategy of devaluation, then all the pressure to undertake reform disappears. Indeed, that’s the objective of your exercise.

So it seems to me the system of incentives that Hans-Werner is suggesting today has it backwards in terms of that major component of his program and I would be particularly skeptical of that major aspect of his program. So I have to admit, with great respect for Hans-Werner’s work and the very cogent analysis in the book, I do find a big dis-conjunction between the stated goals and the program proposed to reach it. I’ll look forward to discussing that in more detail.

My other main criticism and the one I want to spend most of my time, on is Hans-Werner’s treatment of his own country, Germany. In fact, in the book, he didn’t say it today, but in the book, he paints Germany as something of a victim of the Euro system, blaming the Euro for much of Germany’s lagging performance in the years before the crisis.

No time today to debate the history of the German economy after unification, but let me just assert that that situation has totally changed. Today Germany is an island of prosperity and stability within a very depressed neighborhood. Indeed, Germany may in fact now be the only country that is benefiting, at least benefiting very much, from the Euro and therein in my view lies the heart of much of the current problem that I will be describing in the next few minutes.

As Adam said, I spent two weeks in Berlin in June. I gave a series of lectures. I talked to all the top officials in the German government. One of them said to me, “Frankly, Germany is at the bliss point in economic terms. Unemployment is very low. Inflation is nonexistent. The budget is balanced. We have decent growth. We have huge external surpluses,” that despite Hans-Werner admonition, most Germans love, running at 6 to 8% of the GDP and Germany is again the number one creditor country in the world or about to become it, And all this bliss point, to repeat is, in the midst of a depressed neighborhood where everybody else is in big trouble.

Now how did this shift happen? How did Germany move from being the sick man of Europe a decade or so ago to this current economic nirvana state? Well, first and foremost it’s got to do with the hard work and high productivity of the Germans, as always. But policy had a lot to do with it. The Agenda 2010, implemented under the Schroeder government and inspired to a significant extent by Hans-Werner and his colleagues at the Ifo Institute, give credit where credit is very much due on that, that led to significant labor market reforms in Germany, the like of which are needed now in the deficit countries. They have a model. Germany did it. They need to follow up, but Germany certainly did it.
But then that was in turn greatly intensified by the famous German Social Contract. The German government, companies and labor got together and decided to suppress wages. And for the last decade the German social compact has kept real wages flat. There has been no increase in German real wages for a decade throughout the period of the crisis. And remember, this is the surplus country that one would not want to be building up competitiveness and a big surplus. So German wages have been flat, which means that the German establishment engineered a huge internal devaluation of the German economy.

Hans-Werner in his book quantifies an estimate that that was 20 to 25%. He even put a 31% number on the board this morning. In other words, a huge internal devaluation. Martin Wolf, in a series of columns in the FT has repeatedly called it a competitive internal devaluation because it put tremendous pressure on the rest of the Eurozone and was an important major cause of those cost differentials and losses of competitiveness in the periphery to which Hans-Werner pointed and to which he emphasized.

And here is the punch line; that competitive internal devaluation in Germany was possible because of the Euro. First the internal effects. When the Germans engineered their wage suppression and internal devaluation they were doing so in a fixed rate system against the rest of Europe. So there was no appreciation of a German currency to offset the effects against the rest of Europe and therefore Germany’s competitive position vis-à-vis its Euro neighbors, expanded enormously.

But the external situation was even better. Here was Germany dramatically increasing, improving its cost competitiveness but its currency vis-à-vis the rest of the world was not only a flexible rate, it was a rate determined, not just by Germany, but by the entire Eurozone, including the weaker countries. So what Germany wound up with was the best of all worlds. The world’s biggest trade surplus and a weak currency and the Euro is weakening again today. So there was no adjustment process.

Back in the old days, Germany would have an export like boom, the Deutsche Mark would appreciate, Helmut Schmidt would complain about it, but the result was some adjustment. None at all, neither internal to the Eurozone nor external to the world as a whole.

And so the economic nirvana described to me by German officials two months ago, can be clearly understood as an important part of function, a result of the Euro system. And Germany clearly then side, comes across as the basic major beneficiary of the whole Euro system.
Had there been a Neue Deutsche Mark, had Germany moved outside the Euro system as some propose, had there been a marked mechanism in the old days as Hans-Werner would like to see, that Neue Deutsche Mark would have gone up at least 20%, probably 40% or more, in the wake of this improvement in the German competitive position. But none of it happened, internal or external, as a result of the Euro system. Therefore, Germany winds up with the best of all worlds, and indeed, because it doesn’t even have its own exchange rate, the rest of the world can’t even criticize it. We criticize China and others for manipulating their exchange rate. Can’t do that with Germany because after all, it doesn’t have an exchange rate of its own.

So the result of all this is for Germany, as I say, an economic bliss point. But it’s too good to be true. The reason, of course, is then that the rest of Europe is coming to view Germany as the only beneficiary of the Euro system. Resentment is growing. It had to be a major factor in those recent European parliamentary elections, so doubts are rising about whether the system will be politically sustainable.

It would be an enormous irony if having come through the market crisis phase of the Euro system, both from 2010 to 2012, when things were very uncertain and even since 2012, since Draghi’s statement about doing whatever is necessary has calmed the markets, it would be a huge irony after that evolution to now move into a phase where political resentment against the leading country caused the problem. Therefore, it seems to me, it’s absolutely essential for Germany to take the lead in a new Phase III, where financing is no longer the objective of the exercise, but real adjustment is.

Hans-Werner here, and I give him credit with his final comment, pointed the way by suggesting that Germany needs an internal revaluation of something on the order of 20 to 30%. But he’s a little bit misleading and putting up a straw man when he says, “Germany would have inflate by 71% to solve the problem.” Nobody says Germany should solve all the problem, but maybe half. Nobody says Germany should do it immediately or even within a short period of time, but over a period of a decade or even 20 years, as his book suggests, Germany could see its inflation inch up a percentage point a year to maybe two-two and a half. Let wages grow three-three and a half, ease up a little bit on the fiscal austerities, since they’ve got a balanced budget of the world’s biggest credit country. A program I think is quite feasible through which Germany could lead an adjustment phase to really begin resolving the fundamental Euro crisis.

Thank you.
Adam S. Posen: Thank you Fred and of course thank you Hans-Werner. I’m sure our distinguished guest wants to respond to our distinguished discussant. We also want to have time for questions from the floor. So I’ll just ask him to just briefly say what he things of what Fred said.

Hans-Werner Sinn: Well yeah, thanks a lot. This is a valid point of view, which you represent. I know this very well. Most people argue that way. But concerning the details. First of all, German inflation to solve some of the problem is indeed necessary and I advocate that in the book. So what you said towards the end of your presentation here is exactly what the book advocates, but not 70%. Seventy percent results if no one cuts its prices.

If some countries are willing to go through some deflation, then Germany’s inflation by 25-30% would be enough. But if no one wants to cut their prices, then that’s what the calculations show, German inflation would have to be 70%. That is my prediction. A little bit too much for the Germans to tolerate.

Concerning the whole message of the book. The book does not make the main point that Germany is the victim. The victim is everyone and in particular Southern Europe, as I emphasized in my talk. We all fell into a trap because the Euro created so much distortion in the whole system that no one can really be happy with the final result.

And the most sufferings I see, of course, is in Southern Europe, as I explained. We have close to 60% youth unemployment in Spain and Greece. This is already a catastrophe. I wonder how long we want to tolerate this catastrophe. This is a sin to the people, the ordinary people, who have nothing from rescuing the financial markets. It leads to extreme political parties in Europe, which take up this protest from the people and who knows where Europe will be left. The political dangers by destabilizing the societies in the government sectors, I find much, much bigger than the risk of a financial crisis. I see the risk of a financial crisis. You’re perfectly right in pointing out the difficulties with exits. Every economist can spell out the difficulties that will happen.

But the true difficulties and dangers in Europe are much more grave than a financial crisis. What happens if Lupin wins the next election? What happens if [inaudible 01:09:18] wins in Greece the next election? What happens if Catalone, because of the desperate situation separates in this autumn? I mean, these are the real problems. This unresolved competitiveness problem creates a political momentum, which will destroy Europe if we don’t do anything against it. And therefore, I think that more radical solutions are necessary of the kind of which I describe.
I know exactly that you’re right with all the description of all the terrorists; that could happen. We have to compare terrorists with terrorists. And the question is where the terrorists are bigger and my point is that the whole financial industry discussing these issues, just looks at their portfolios and underestimates the political risk that results from a policy of continuing what we have done.

And now concerning two further points, gold standard. America had a gold standard for internal settlements between the district Feds until 1975. Don’t forget that. It is not possible to allow National Central Banks to print the money if they can’t borrow it. There must be some constraints. And here the constraint is if you do that, then you explicitly borrow and you have to compensate the others with gold. American had that between its 12 district fence and only when the Bretton Woods system failed, did American go over to another sort of settlement with assets. So it’s not that observed as it may sound.

And then Germany, my point is, which I explained clearly that Germany is in a boom now. Why is it in a boom? It is a boom because of the crisis. Because the crisis meant that German investors, financial institutions, don’t dare to finance investment in Southern Europe, they’d rather finance German housing. People who have money invest in real estate. So we have a real estate bubble at the moment that creates a certain type of prosperity.

But this little bit of extra growth, which we got out of it during the crisis relative to the others, has not prevented Germany’s GDP per capita from falling from the second level. It had in 1995 among the now Euro countries, to the seventh rank today. We fell to the eighth rank during the time when the Euro seemed to function and then during the crisis we came back from the eighth to the seventh rank.

So what happened, Germany was 10 years ago, not competitive. Its wages were too high, many reasons. Then there was the fall of the Iron Curtain. Low wage competitors at your doorstep. And then came the Euro with all sorts of low wage competitors without customs, barriers and the same currency, which made life very hard for German industry.

And then in addition, the Euro told investors, “You can go to Greece and buy the government bonds. You can finance the Spanish real estate sector.” This all was gold that glittered more than any ordinary investment in Germany. Germany, at the time, had the lowest investment rate among all OECD countries in GDP. So it stopped growing.

And this is the law of capitalism, let me end with that. If capital goes from A to B, A being Germany and B being Southern Europe, then B goes into the boom. The booming region develops its incomes and imports more. It
gets a current account deficit. And the slump region, where you don’t have 
the investment anymore, gets a current account surplus because the 
incomes grow very little, the imports grow very little, and if anything the 
export competitive increases to the relative price effect. So you get in the 
slump region, a current account surplus.

Germany, throughout the time when the Euro seemed to function, was the 
sick man of Europe. Little noticed outside Germany. I wondered always 
why that was the case.

Adam S. Posen: Hans-Werner, I’m afraid I have to stop you. I’m going to skip putting in all 
the ways I would correct both Fred and Hans-Werner, in the interests of 
allowing our guests some time. As usual we have a microphone at the 
front. For those at the back you can go to the standing mic. Please identify 
yourself when you speak and when I recognize you. And please pretend 
you’re asking a question. First to Warrick.

Warrick McCubbin: Thanks very much, Warrick McCubbin from the Brookings Institution. I 
agree very much with Hans-Werner’s presentation and diagnosis. One 
question I had, one option we muddled, as well as the policies you 
propose, is to take the Eurozone, switch it into a dual currency zone with a 
40% internal devaluation of the South relative to Germany.

Now what that does is it does cause a boom in Southern Europe, but it 
causes a deep recession in Germany, particularly German durable goods 
exports to Asia collapse. It does, however, leave you five or six years of 
adjustment where the real economies can recover in the South.

Do you think that your currency adjustment within the Eurozone is 
feasible and do you think it’s something that Germany would resist 
because of the fundamental problem that Fred really pointed out, and that 
is the Euro itself is helping propel Germany’s prosperity through the under 
evaluation of its exchange rate?

Hans-Werner Sinn: Yeah, we are in an artificial prosperity with 7.3% current account surplus. 
Germany’s current account surplus this year is 200 billion Euros. It’s the 
biggest capital exporter of the world. It’s a completely strange and 
artificial and unsound thing, because what one accumulates are assets in 
rescue operations and claims against the ECB system. It looks very good 
because people have jobs. But you export goods for dubious claims and 
the whole economy is distorted. This is one of the illusions which 
politicians have, which I called mercantilism, that they think this sort of 
export boom is something they can live on for a longer period.

When the German baby boomers are 50 years of age in 15 years, they 
want their money back because they go into pensions. From whom? From
people who have received their rescue funds, so they will not repay. I think this is not a solid path on which Germany and the rest of Europe is developing.

So we need a revaluation, either through inflation inside the Eurozone or through some currency realignments through a breathing currency union. But what I don’t like is to cut the Euro in half, as some propose, because of the political implications. The German-French understanding [inaudible 01:16:51], is the driving pillar, the pillar of the European Union and the post war system. That should not be put at risk.

So as much as from a purely economic perspective you could say, “Let’s have France in another currency area than Germany and have them devalue.” That is not possible. What I think is possible, however, is that some smaller countries at the margin leave temporarily. Greece really has no chance. They are twice as expensive, to some extent, or 40% more expensive than Turkey is. Turkey is the city next door. It’s the same country, the same products. It is impossible for Greece to ever prosper under these conditions. So it would be much, much better for Greece if they exited.

Of course, one has to solve the foreign debt problem because then the debt remains in Europe. You have to have a haircut for the debt at the same time. But then the work would really be better for the Greek population because the Greeks would begin to buy their own products. Now they have a current account deficit in agriculture products, which is about the only thing where they have a comparative advantage. They buy agriculture products in net terms from other countries and otherwise they have nothing to export. This is also an unsustainable, absurd situation. Let the Greek buy products from their farmers because the farm products become more expensive. Then the farmers create jobs and that’s one of the ways to get this country going.

Adam S. Posen: Thank you. Here at the front table and then directly behind him.

Felix: Felix [inaudible 01:18:44] from the IIF. Going back to Germany, you mentioned before Germany is in a boom. Why is it that German inflation is barely above 1%? Shouldn’t that adjustment be happening already? And it’s creating all these headaches at the ECB level with keeping your area inflation down. So what is holding back German inflation?

Hans-Werner Sinn: Yeah, I think that is the European rescue operations. Again, Germany is the largest capital exporter in the world. Much capital was flowing to Southern Europe. The investors now shy away and don’t want to go. They invest in German real estate. We have a boom in the labor market. Wages are increasing rapidly, have been increasing rapidly recently. There was a
pressure on prices that would have reduced the competitiveness of the export industry, good, so it would have improved the terms of trade.

But this process, the self-correction, which the markets would have realized, is now undermined through the policies of the ECB, because the ECB says, “No we don’t want that. We don’t want this money to be invested in Germany. We’d rather give incentives and public guarantees so that it goes to Southern Europe, because they need the money.”

Well that is one of the reasons why the German boom is not strong enough to create this inflation. You cannot have it all. You can’t have the investment in Southern Europe and create an inflationary boom in Germany at the same time. You have to decide what you want. And politicians, I don’t claim the ECB doesn’t understand that, but politicians do not understand, for example, that a country which has a current account surplus, is exporting capital. The EU claims Germany should reduce its current account surplus because it is stealing markets from other countries. At the same time, the EU wants Germany to export more public capital to other countries. How come? Impossible, given that most of our current capital export is a public capital export anyway.

Adam S. Posen: Okay, the last question, the gentleman there at that table.

Alex: Yeah, Professor Sinn. Alex [inaudible 01:21:08] with NCGS. I wanted to ask you something about the latest monetary policy decisions taken by the ECB. Not because of the monetary aspects of them, but mostly because of the speech that preceded those decisions that Mario Draghi held in Jackson Hole. Basically, almost echoing the sort of the Abenomics approach of the three arrows saying that Europe needs to work on the supply side, on the demand side and on the monetary policy side.

What is it about what Draghi said in Jackson Hole that you, and you are looking for a solution to the problem, don’t like? Why is that approach not workable or if it is workable, wouldn’t that approach be a more realistic way to get Europe on a path out of the slump? Thank you.

Hans-Werner Sinn: Not out of the slump. It is something that alleviates the pain. It’s a Keynesian demand management, by allowing the countries to borrow more. Well that is not the only thing, he also wants structural reforms and here I clearly endorse what he says. But I think we have had too much Keynesian demand management throughout the crisis and that money out of the printing press, money out of the rescue operations, these public guarantees for investors going to Southern Europe, has helped the Southern countries to postpone the reforms.
What has happened in Italy? Nothing has happened in Italy. Berlusconi, the only time that he dared some reforms was when the interest rates went up and then the ECB intervened, the interest rates came down and then he said, “Oh no, I did not really mean it.”

Then came Mario Monti. Mario Monti was trying to carry out reforms and then the ECB came with its LTRO and helped the banks get the funding. So they put the pressure out of the system and then politically Mario Monti could not carry out his reforms.

This is unfortunately the case. The reforms come only under pressure and if you take the pressure away through monetary and Keynesian relief operations, then the reforms will not take place.

I showed you that Italy did not do a bit of an internal devaluation, even though they suffered from 70 years of crisis.

Adam S. Posen: Now unfortunately, we’re out of time. I have to at least say for the record there are many of us who have the exact mirror image view of Hans-Werner’s last statement, that what has been demonstrated over the last seven years is that the imposition of austerity works against structural reforms. That controlling for the business cycle, these countries actually did engage in austerity. That the ECB never did what it was supposed to do and that that made the crisis worse. That’s at least an alternative point of view.

But we are grateful that Hans-Werner Sinn came here to give us his alternative point of view. He is always welcome to do so and we look forward to continued exchange with him and the staff of CESifo. He’s been gracious enough to host some of our people. We look forward to continuing that Home and Home series. Maybe it’s the think tank champions league, the Bundes League, and I’d like to think we’re a little bit better than US major league soccer.

Thanks as well to my friend and mentor, Fred Bergsten, for reminding us of Americans who believe in the Euro. And this meeting is adjourned.